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No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1992

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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TABLE OF AUTHORITIES

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1. a. Respondents (Br. 9, 17-18) and *amici* (Br. 7-10) assert that, under Section 1016 of the Code, all capital improvements to an asset are "properly chargeable" to the capital account of that asset. They therefore contend that, both under Section 1016 and for purposes of calculating the depletion tax preference under Section 57(a)(8), the cost of "improvements" associated with a "mineral enterprise" are to be added to the basis of the "mineral deposit." These assertions, which also form the basis of the decision in the courts below (Pet. App. 7a-9a), are fundamentally flawed.

Some types of "improvements" to an asset are so completely merged into that asset that the cost of the "improvements" are commingled with the costs of the

asset into a single basis for tax accounting purposes. A simple example is a "new and improved" component placed in manufacturing machinery; the component represents an "improvement" to the machinery, and its costs are added to the adjusted basis of the machinery. The costs of such an "improvement" are to be recovered through the depreciation (or disposition) of the resulting, combined asset. See, *e.g.*, 26 C.F.R. 1.1016-2(b); *Jefferson Memorial Gardens, Inc.* v. *Commissioner*, 390 F.2d 161 (5th Cir. 1968) (cost of streets and similar improvements to a subdivision are allocated among the bases of the subdivision lots).

Other types of "improvements" *themselves* represent separate assets and their costs are maintained, and recovered, in separate accounts for tax purposes. For example, a new machine added to a factory may be said to represent an "improvement" to the manufacturing enterprise, but the costs of the machine and the factory are *not* commingled into a single basis. Instead, separate capital accounts are maintained for the factory and the "improvement" and the costs of the two assets are recovered independently. See, *e.g.*, *Noell* v. *Commissioner*, 66 T.C. 718, 723-724 (1976) (air strip built on land within subdivision is a separate asset and its costs are not allocated to the bases of the subdivision lots).

The tax accounting applicable to a "mineral enterprise"—which, by definition, consists of a "mineral deposit * * * and improvements" (26 C.F.R. 1.611-1(d)(3))—is of the latter type, for the costs of tangible "improvements" to the mineral enterprise are separately accounted for and separately recovered. The costs of the "mineral deposit"—which represents the "minerals in place"—are maintained in a

capital account for that deposit and are recovered by the allowance for depletion. 26 U.S.C. 611(a). The costs of associated tangible improvements—such as wellhead equipment and piping—are maintained in an "improvements account" (26 C.F.R. 1.611-2(b)(2)) and are recovered upon their sale or by an allowance "for depreciation of improvements" (26 U.S.C. 611(a)).[1] To emphasize that a separate accounting is required for the depletable costs of the "mineral deposit" and the depreciable costs of "improvements" to the mineral enterprise, the regulations specify that "[i]n no event shall percentage depletion in excess of cost or other basis of the [mineral deposit] be credited to the improvements account" (26 C.F.R. 1.611-2(b)(2)).[2] See also 26 C.F.R. 1.612-1(b)(1) (the basis of a depletable mineral deposit "*does not include* * * * [a]mounts recoverable through depreciation deductions") (emphasis added).[3]

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[1] The tangible "improvements" to an oil well, such as pipes and wellhead equipment, are removable, separately valuable, and have useful lives of varying lengths reflected in applicable depreciation schedules. The costs of such improvements are recoverable by depreciation. By contrast, the term "mineral deposit" refers "to minerals in place" (26 C.F.R. 1.611-1(d)(4)), and the costs of a mineral deposit are recoverable through depletion.

[2] The regulation uses the word "property" instead of "mineral deposit," as reflected in the brackets in this quotation. See 26 C.F.R. 1.611-2(b)(2). The regulation defines the word "property," however, as the "mineral deposit" in which the taxpayer owns an interest. 26 C.F.R. 1.611-1(d)(1)(i).

[3] Respondents and *amici* implicitly acknowledge that this regulation, if applicable, disposes of their claim. But they contend (Resp. Br. 14-15; Amicus Br. 10, 17-18) that the

These long-standing statutory and regulatory provisions thus expressly provide that the cost of a depreciable "improvement" to a mineral enterprise is *not* "properly chargeable" (26 U.S.C. 1016(a)) to the capital account of a "mineral deposit." [4] See also

regulation is of limited significance because it describes the calculation of the basis of the mineral deposit only for *cost* depletion purposes. That contention is in error. The same calculation applies in determining the basis of the mineral deposit whether *cost* or *percentage* depletion is employed. The percentage depletion regulations emphasize this point, for they specify that a percentage depletion deduction in excess of the basis of the mineral deposit may *not* be credited to the separate "improvements account" that is to be maintained for depreciable improvements. 26 C.F.R. 1.611-2(b)(2). Since the percentage depletion allowance may not be credited to the "improvements account," and is therefore not to be employed to recover the basis of depreciable improvements, the cost of such improvements obviously is not to be included in the basis of the depletable mineral deposit. Both for cost depletion and percentage depletion purposes, the basis of the depletable mineral deposit thus "does not include * * * amounts recoverable through depreciation deductions" (26 C.F.R. 1.612-1(b)(1)).

[4] Respondents contend (Br. 11-12) that the provisions of Section 1016 that allow additions to basis only of costs "properly chargeable" to the capital account of an asset (26 U.S.C. 1016(a)) serve only to distinguish between currently deductible and capital expenses associated with "improvements." Certainly, only capital expenses are "properly chargeable" to basis; currently deducted expenses, by definition, have been recovered and should not be included in basis. As we have explained in the text, however, the costs of *separate* assets, to be recovered under *separate* methodologies, are also *not* to be commingled into a single basis and are thus not "properly chargeable" to the same capital account. See *Tolwinsky* v. *Commissioner*, 86 T.C. 1009, 1054 (1986) (the expenses "'must be made *with respect to such property*' in order to be included in the depreciable basis of such property") (quoting 3A J. Mertens, *Law of Federal Income Taxation* § 21.22 (1977)); *Purvis* v. *Commissioner*, 65 T.C. 1165, 1168 (1976) (the expense must represent "an addition" to the asset). The separate bases maintained for *depletable* mineral deposits and for *depreciable* improvements (see 26 C.F.R. 1.611-2(b)(2)) are a classic illustration of this principle.

Holbrook v. *Commissioner*, 65 T.C. 415, 420 (1975) (improvements consisting of depreciable equipment do not constitute capital investments in the minerals in place). The cost of depreciable improvements therefore may *not* be added to the basis of the depletable mineral deposit in determining the amount of percentage depletion that constitutes a tax preference under Section 57(a)(8) of the Code.[5] See Pet. Br. 15-28.

The legislative history of Section 57 reflects this very conclusion, for, in amending and reenacting Section 57(a)(8) in 1986, Congress expressly stated that only the unrecovered basis of the "depletable" mineral deposit may be considered in calculating the tax preference resulting from the percentage depletion allowance. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 254 (1986); Pet Br. 26. The many commentators who have addressed this issue have uniformly reached that same conclusion. See

[5] Examples of improvements whose costs *may* be added to the basis of the mineral deposit, and which are recoverable through depletion, are intangible drilling costs that are not currently deducted. See 26 C.F.F. 1.612-4(a), (b)(1) and (b)(2). As we explain in our opening brief (at 26-27), these capitalized intangible costs have long been recognized as a part of the cost, or an addition to the value, of the oil in the ground. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 466 (1933).

Pet. Br. 26, 30 n.20. See also Lawson, *Alternative Minimum Tax: The Percentage Depletion Tax Preference for Investments in Natural Resources After* Hill *v.* United States, 7 J. Min. L. & Pol. 211, 217 (1992) (the court of appeals "reached the wrong conclusion in *Hill*").[6]

b. All of respondents' contentions miss, or evade, the basic fact that the mineral deposit and the associated "improvements" to the mineral enterprise represent separate properties, each with its own capital account and basis. They are treated separately precisely because they are subject to different methods of cost recovery. See *Commissioner* v. *Ferrer*, 304 F.2d 125, 135 (2d Cir. 1962) (separate bases must be maintained for two closely related assets when "part of a transaction calls for one tax treatment and

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[6] "Although the difference between depletion and depreciation was not recognized by the *Hill* court, many other authorities have understood the distinction. For example, the Tax Court held in *Clemente, Inc.* v. *Commissioner* [50 T.C.M. (CCH) 497 (1985)] that a proper computation of the depletion allowance for a property should be determined only after removing the nondepletable assets from the basis. The Internal Revenue Service (IRS) held in a revenue ruling that the cost of acquiring a mineral enterprise should properly be allocated between the property's depletable and depreciable bases. [Rev. Rul 69-539, 1969-2 C.B. 141.] Also, tax commentators on natural resources have agreed that 'the [property's] depletable basis does not include * * * wasting assets such as equipment and improvements that are subject to * * * depreciation.' These authorities uniformly agree that depreciation and depletion are entirely separate concepts for purposes of regular and minimum tax; therefore, the *Hill* court contradicted logic and reason by allowing unrecovered tangible costs to be included in the property's depletable basis." Lawson, *supra*, 7 J. Min. L. & Pol. at 220 (footnotes omitted).

another for a different kind"). If, as respondents assert (Br. 12-13), depreciable tangible improvements "are not separate properties * * * because they are additions to and become part of the property improved," then the costs of depreciable improvements necessarily would be recovered by depletion, rather than by depreciation. Both the statute (26 U.S.C. 611(a)) and the regulations (26 C.F.R. 1.611-2(b)(2)) make clear, however, that the costs of tangible improvements are separately maintained in an "improvements account" (*ibid.*) and are to be recovered by the allowance for "depreciation of improvements" (26 U.S.C. 611(a)), not by depletion.

c. *Amici* fundamentally misstate our position by asserting (Br. 10) that the government "agree[s] that when the *mineral property* is sold, the adjusted basis for computing gain or loss must include these tangible improvements" (emphasis added). The portion of our brief that they cite (Pet. Br. 24) does not support this statement. Instead our brief states that, while tangible "improvements" (*ibid.*)

> may be properly includable in the basis of the "mineral enterprise" for the purpose of determining gain on sale of the mineral enterprise as a unit * * * , those depreciable "improvements" have their own capital accounts, separate and distinct from the capital account of each depletable mineral deposit that is a component part of the mineral enterprise.

The term "mineral property," used by *amici* (Br. 10), is a defined regulatory term that refers specifically and exclusively to the "mineral deposit" (26 C.F.R. 1.611-1(d)(1)). The term "mineral enterprise," used in the cited quotation from our opening

brief (Pet. Br. 24), is also a defined regulatory term that refers *not* to the mineral "property," as *amici* erroneously suggest, but to the "mineral deposit * * * and improvements" (26 C.F.R. 1.611-1(d)(3)). By blurring the distinction between the term "property" ("mineral deposit") and the term "mineral enterprise," *amici* seek to blur the very issue presented in this case. For, in calculating tax preference income in Section 57(a)(8), Congress has allowed the taxpayer to set off only the adjusted basis of the "property" (defined as the "mineral deposit") and *not* the adjusted basis of the entire "mineral enterprise." See 26 U.S.C. 57(a)(8) (1976), incorporating 26 U.S.C. 614. The courts below erred precisely by allowing a deduction of the basis of the entire "mineral enterprise" in this calculation, for they allow the taxpayer to set off the basis of the "mineral deposit * * * and improvements."

In enacting Section 57(a)(8), Congress legislated against the background of these clear statutory and regulatory distinctions. If Congress had intended the result adopted by the courts below, Section 57(a)(8) would have referred not to the adjusted basis of the "mineral deposit" but to the unrecovered costs of the "mineral enterprise." By adhering to the long-standing distinction between the separate capital accounts maintained for the depletable mineral deposit and for depreciable tangible "improvements," Congress properly focused the tax preference calculation on the area of its concern. For, as we have explained (Pet. Br. 16-21), it is excess depletion of mineral deposits, not the ordinary "depreciation of improvements" (26 U.S.C. 611), that makes the depletion allowance potentially unfair and subject to economic abuse.

d. Respondents (Br. 11 n.9, 15-16 n.16) and *amici* (Br. 19-20) erroneously assert that the position of the United States in this case is inconsistent with Tech. Adv. Mem. 83-14-011, issued by the Internal Revenue Service on December 22, 1982.

By statute, this memorandum (and other similar informal advice from the Service) "may not be used or cited as precedent." 26 U.S.C. 6110(j)(3). The memorandum, in any event, concerns the special treatment afforded to a category of mining costs described as "deferred" "development expenditures" (26 U.S.C. 616(a), (b)), a category of costs that does not exist for any "oil or gas well" (26 U.S.C. 616(a)). The memorandum concludes that such deferred development expenses—which may *not* include the costs of assets that are "subject to * * * depreciation" (*ibid.*)—may be included in the adjusted basis of the "property" in calculating the depletion tax preference under Section 57(a)(8). This conclusion simply implements the plain language of Section 616(c), which specifies that the deferred development expenses described in the statute "shall be taken into account in computing the adjusted basis of the mine or deposit" (26 U.S.C. 616(c)).[7]

The Service stated in that memorandum that the "adjusted basis' of the property is a term that has the same meaning in Section 57(a)(8) as it has "elsewhere in the Code." The Service's position in this case is consistent with that statement. It is, after

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[7] The deferred development expenses described in Section 616 are analogous to the intangible drilling costs that are included in the basis of a mineral deposit when the taxpayer elects to capitalize, rather than deduct currently, those costs. See Pet. Br. 17-18 n.12; note 5, *supra*.

all, the Service's view that the adjusted basis of the depletable "mineral deposit" is the same for purposes of the tax preference calculation under Section 57(a)(8) as it is under Section 611 and "elsewhere in the Code." It is *respondents* who claim that the cost of depreciable tangible improvements should be added to the basis of the mineral deposit under Section 57 even though, under Section 611, those improvements are separately accounted for in an "improvements account" (26 C.F.R. 1.611-2(b)(2)), with the associated costs recovered by "depreciation of improvements" (26 U.S.C. 611), rather than by depletion (26 C.F.R. 1.611-2(b)(2)). See pages 1-7, *supra*.

For more than fifty years, the statute and regulations have consistently required that depletable mineral deposits and depreciable tangible improvements be treated as separate items of property. During that same period, the Service has consistently expressed that same requirement (G.C.M. 17,760, 1937-1 C.B. 102, 104-105):

> The Bureau has consistently required the owners of improved mineral property to keep separate accounts for depletable and depreciable property * * *.
>
> * * * [This] requirement renders it necessary that the basis of depletable property be set up as an item separate from the basis of depreciable property.

See also *Holbrook* v. *Commissioner*, 65 T.C. at 420; Russell & Henderson, *Purchase of a Producing Oil and Gas Well: Is Cost of the Cased Shaft Recoverable Through Depreciation?*, 35 Oil & Gas Tax Q. 177, 179 (Dec. 1986) ("'Improvements' and 'oil and gas in place' are mutually exclusive. Improvements are depreciated; oil and gas in place is depleted.").

2. In enacting the minimum tax, Congress sought to capture and tax the special benefit that excess percentage depletion deductions provide for mineral producers because that benefit creates "an unfair distribution of the tax burden" (S. Rep. No. 552, 91st Cong., 1st Sess. 112 (1969)) and "impair[s] the equity of the tax system" (S. Rep. No. 938, 94th Cong., 2d Sess. 109 (1976)). As explained in our opening brief (at 28-31), this clear, expressed intent of Congress is frustrated and impeded by the decision in this case, which (i) illogically combines the unrecovered costs of depreciable tangible assets with the basis of the depletable mineral deposit in determining the tax preference resulting from *excess depletion* and (ii) allows the taxpayer to set off the unrecovered balance of depreciable costs *each year*, even when the depletion allowance in the prior years far exceeds the taxpayers' basis both in its depletable *and* depreciable property (see Pet. Br. 6 n.6). For these reasons, as commentators have uniformly concluded, the result reached by the court of appeals is "completely inconsistent with the purpose of the minimum tax" (Lawson, *supra*, J. Min. L. & Pol. at 221).

Respondents do not attempt to justify these obvious logical flaws in the decision below. Instead, respondents suggest that it is "conceivable" (Br. 19) that Congress silently intended to adopt such an illogical scheme in order substantially to mitigate the effect of the minimum tax on the incentive that percentage depletion provides to mineral development. But the "incentive" that respondents claim Congress silently sought to protect is simply the financial flipside of the "inequity" that Congress expressly sought

to curtail in the minimum tax. Boiled down to its essence, respondents' suggestion appears to be that the clear language of Section 57(a)(8)—which invokes the established and logical distinction between depletable mineral deposits and depreciable tangible improvements and implements the express congressional policy to employ the minimum tax to enhance the equity of the tax system—should be ignored because Congress "conceivabl[y]" might have intended some other, contrary result. That contention, of course, lacks any support. By entrenching the same "unfair distribution of the tax burden" that the statute is designed to correct (S. Rep. No. 552, *supra*, at 112), the courts below erred in their reading of the language, the history and the purpose of the statute.

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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